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**5. Author (s)**

1. Robert C. Rice
- 2.
- 3.

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# PRODUCT RESERVATION AND OTHER POLICIES TO INCREASE DEMAND FOR THE PRODUCTS OF SMALL ENTERPRISES COMPARED WITH SOME ALTERNATIVE POLICIES<sup>1</sup>

Robert C. Rice, Partnership for Economic Growth (PEG)<sup>2</sup>, Small and Medium Enterprise Advisor, State Ministry of Cooperatives and Small and Medium Enterprises

In this paper we critically assess government policies which have been used to increase the demand for products of small enterprises, especially product reservation schemes and government procurement policies favoring small enterprises (SEs). We compare these policies with policies designed to increase the competitiveness of small enterprises, such as subsidized credit and subsidized unskilled labor. We take as given that it is desirable to promote the development of small enterprises

## PRODUCT RESERVATION POLICIES

In this section we examine some results of product reservation policies for small enterprises in India, small and medium enterprise (SME) promotion policies in Taiwan, and the Indonesian product reservation scheme.

### India

Some countries have reserved the production of particular products for small enterprises. One country which has had these schemes for many years is India<sup>1</sup>. In this section we discuss theoretically the arguments **in favor of** and **against** these schemes, utilizing especially the experience of India.

Perhaps the most common **economic argument** in favor of small enterprise product reservation schemes is that small enterprises commonly have much higher labor capital ratios than larger enterprises, and in countries with very high levels of open and disguised unemployment it is desirable to promote small enterprises relative to larger ones because they utilize more labor and less capital per unit of value-added. A government also may want to promote small enterprises for social or economic reasons.

The above **economic argument** in favor of small enterprises is not necessarily valid. Firstly, in practically all circumstances the employment of labor is a cost, not a benefit. If labor is employed to produce nothing it is a waste. Only if the social cost of production is less using

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more labor and less capital (more labor intensive) than the social cost using more capital and less labor (more capital intensive) is the utilization of the unemployed labor desirable by using the labor intensive production process. What we do find in many countries, including in Java, is that the social cost of labor is less than the monetary cost because the social or shadow wage rate is less than the market wage rate. The World Bank and Asian Development in appraising development projects commonly calculate both the financial internal rate of return (FIRR) and economic internal rate of return (EIRR), with the latter calculation being done using shadow prices and taking into account external economies and diseconomies produced by the project. A major factor making the FIRR less than the EIRR is that the wage rate for unskilled labor is greater than the shadow wage rate (the social cost of labor) in very densely populated regions with extensive unemployment.

Let us now compare a small enterprise and a large enterprise producing the same commodity (good or service) using different technologies. We assume that the social cost of labor is less than the private cost, and there are no other divergences between private and social cost, and there are no externalities. We examine three cases:

- 1) In case one, the small firm uses both more labor and more capital to produce the commodity than the larger firm. Clearly both its private and its social cost of production are higher than the larger firm, and therefore it is desirable in economic terms that the larger firm produces the commodity.
- 2) In case 2, the smaller firm uses more labor and less capital to produce the commodity than the larger firm. However, still both its private and social costs of production are higher than the larger firm, and therefore again it is desirable in economic terms that the larger firm produce the commodity.
- 3) In case 3, the smaller firm uses more labor and so much less capital to produce the commodity than the larger firm that its **social cost of production** is less than the larger firm. In this case it is desirable in economic terms that the small firm produce the commodity. However, if production is determined by the market, the result **may or may not be** that the smaller firm also has a lower **private cost of production**, and therefore is able to be competitive relative to the larger firm and therefore produce the good. There is the possibility that the larger firm may have a lower private cost of production, and therefore be more competitive in producing the good, even though it has a higher social cost of production than the small firm. In this case the market produces a **socially undesirable result**, and there may be a case for government assistance to smaller firms, if the cost of that assistance is not too large relative to the benefits it produces in the form of producing output at a lower social cost.

Quite often in developing countries we find that small firms cannot access very much credit at the social cost of capital, i.e. at an interest rate which reflects the social cost of capital to them, but instead have to access most of it from money lenders at exorbitant interest rates, while larger firms can borrow at an interest rate equal to the social cost of capital to them. If this is the situation, then it also causes the private cost of production of the small enterprises to be greater than their social cost, while the social and private costs of production of the larger enterprises are equal.<sup>ii</sup> This too, as in the case mentioned above with the private cost of labor being greater than

the social cost, results in small enterprises being less competitive relative to larger enterprises than they should be in social terms, and the proportion of their output being less than is socially optimal.

In both of these cases, there is a **market failure** argument for the Government to assist the small enterprises. The question then is what are the most attractive ways of providing this assistance and whether it is still attractive to provide assistance after taking into account the cost of that assistance including any cost caused by **government failure**.<sup>iii</sup>

In an economy in which products produced by small enterprises (SEs) are not imported, one way of assisting small enterprises is to ban larger domestic enterprises from producing some or all of the products produced by SEs. Or another way of stating this is, by **reserving the production of certain products for small enterprises**. India has been using production reservation schemes for many years to assist domestic small producers. We now look at some of the disadvantages and advantages of using these reservation schemes.

India presently reserves the production of 821 items for the small-scale industries sector. However, many of these items can be freely imported. Recently rice milling, dal milling, poultry feed, vinegar, synthetic syrups, biscuits, ice cream, a variety of automobile parts and corrugated paper and boards were dereserved (Ministry of Finance, Government of India). "The instrument to implement the policy of reservation was to freeze the capacity of the existing large and medium units manufacturing the reserved items and to deny new licences to large and medium units for the manufacture of these items." However, recently in India, with the decontrol of a large number of industries, "the instrument of licencing is no longer available to Government to implement the policy of reservation." "The policy of reservation has encouraged the larger of the small scale units to grow horizontally rather than vertically merely to stay within the definition of small scale, thus sacrificing the efficiency that could have arisen from economies of scale." (Government of Andhra Pradesh, "Policy for Small Enterprises")

Guhathakurta (1993), in discussing a scheme reserving the production of metal furniture for small enterprises in India, reports that one of the main disadvantages of this reservation scheme is it has adversely affected the efficiency of production of the metal furniture industry and retarded its growth. He reports for India that the larger enterprises are able to produce higher quality products at a competitive price compared with the small enterprises. However, they are not allowed to grow except for their production for export. On the other hand, the small enterprises are not allowed to become medium-sized enterprises with the result that they are unable to produce as high quality goods at low cost as the larger enterprises. When the larger firms expand production for the domestic market they do it by establishing several small production operations, which is allowed, rather than one larger production operation (which is not allowed) which apparently would have resulted in a lower cost of production.

The restrictions on small enterprises growing into medium-sized enterprises (MEs) and restrictions on new MEs being established resulted in much less competition for the MEs and higher rates of profit than for the very competitive small enterprise segment of the industry.

Another result was that because the small enterprises on average paid lower wage rates, the facilitation of the growth of the small enterprises at the expense of the larger ones resulted in lower average wage rates for workers in the industry.

However, this study does find that **one favorable aspect** of the product reservation policy is that it **encourages firms to produce for export**, because if they produce for export they are allowed to become bigger and therefore are able to produce at lower cost. However, this favorable aspect is of little importance because without the product reservation policy presumably the cost of production of the MEs would be the same--or perhaps even lower, and therefore they would have the same incentive to produce for export.

A commonly used alternative way of assisting small enterprises is the provision of subsidized credit. Policies which increase the demand for products of SMEs are more attractive than credit subsidies because, unlike credit subsidies, increasing the demand for their products does not result in a higher capital-labor ratio being used in production. Usually in an economy characterized by surplus labor, such as densely populated parts of Indonesia, a higher capital-labor ratio is undesirable because capital is the scarce and labor the abundant factor of production.

An important weakness of Guhathakurta's study was that no evaluation was done using shadow (accounting) prices. In other words, it is possible that even though the cost of production in money terms of the MEs was lower than the small firms, their cost of production in social terms could have been higher. We do not know from his study.

Ian Little et al in their book also discuss the effects of production restrictions in three industries in India. They also found that their effects were not positive. The Government placed more stringent restrictions on the production of products by textile mills than on the small-scale powerloom producers, and more stringent restrictions on powerloom producers than on handloom sectors. They found that in terms of private profitability, the intermediate sized power looms were superior to both the handlooms and the mills for a range of interest rates between 13 and 46 percent. In terms of social profitability they found that mill operation is socially more desirable than powerloom operation and that power looms are socially more desirable than hand looms, although the results are dependent on which sample of firms is used. The socially attractive mills were restricted in their expansion while power looms and handloom producers were not. To summarize, the **restrictions** on the production of textile mills were **found to be undesirable in social terms** (pp. 39-41).

Sugar in India is produced by the smaller-scale open plan sulfitation (OPS) process (khandsari) and in large mills using the vacuum plan sulfitation process (VPS). The Government restricted expansion of production using the VPS process. Haan in a study (cited by Little et al) found that the net present value of producing mill sugar (VPS process) greatly exceeded that of using the OPS process. He also found that restrictions on production using the VPS resulted in little additional employment. The main beneficiaries of the development of khandsari were rich trader families and large landholders, not the small-scale producers (p. 43).

India also placed product reservations on numerous light engineering industry products. Two effects of restrictions on investment by larger producers of diesel engines were that 1) the ability of the industry to innovate and upgrade technology in the high-speed engine market (characterized by economies of scale) was retarded, and 2) the linkages between large assemblers of components used to manufacture the engines and the many smaller producers of

the components were less than usual. This is because many of the smaller producers were producing slow-speed, low-horsepower diesel engines. In many countries the close linkages between larger assemblers of products and the numerous smaller-scale producers of the components assembled are of great mutual benefit, frequently with the larger assemblers providing technical assistance to the smaller component producers.

In the case of bicycles, many of the bicycle components were reserved for small-scale enterprises, but were not produced to adequate quality standards. This resulted in large firms producing up to 80 percent of their own components in-house or through closely affiliated ancillaries. These reservations on production of bicycle components to small-scale enterprises, also seems to have hindered the development of efficient mutually beneficial relationships between bicycle assemblers and suppliers of component parts.

Little et al criticize a uniform application of reservation policies in the engineering industries. "These policies have clearly acted to reduce any dynamic benefits which might have accrued from innovation in small-scale enterprises and to encourage an industrial structure which inhibited technological development and product upgrading in the more technologically complex product groups. Thus, the effect of capacity restrictions on diesel engines and bicycles has reduced the performance and international competitiveness of these industries more than in the case of hand tool manufacturing"(p. 49).

If the products on which production restrictions are imposed on larger enterprises are also imported, then the main effect of a reservation scheme can be an increase in imports at the expense of domestic production, because domestic producers become less competitive relative to imports as small enterprises replace larger lower cost ones in producing the commodities. With growing globalization and increasingly decreased import duties in the future with ASEAN Free Trade Area, APEC and World Trade Organization agreements, it will become increasingly difficult to restrict imports. Government restrictions on the production of products by medium- and large-scale enterprises (MLEs), could very well result in higher cost domestic production with a resultant increase in imports. Such a policy which restricts increases in production by domestic MLEs and results in larger imports because the small enterprises are not globally competitive, using normal criteria for evaluation, must be considered to be highly undesirable if the small enterprises have a higher social cost of production than the larger ones.

If the small enterprises have a lower social cost of production but a higher private cost of production than the larger enterprises, we have a dilemma<sup>iv</sup>. Production restrictions on larger enterprises do not solve the dilemma because they just result in higher imports, as is shown in Figure 1 below.

Before the ban on the production by larger enterprises, domestic production is OJ (OG + OH, the production of small plus larger enterprises) and imports are JL, with domestic consumption being OL. After the ban on imports domestic production decreases to OG, only the production of the small enterprises, while imports increase to GL, because the production by larger enterprises, OH stops.  $P_m$  is the supply schedule of imports,  $S_{sp}$  is the supply schedule of small enterprises based on their private cost of production,  $S_{Lp}$  is the supply schedule of larger enterprises based on their private cost of production, while  $S_{ss}$  is the supply schedule of small enterprises based on their social cost of production (that is if their private cost of production was

equal to their social cost of production). Assuming that the social and private costs of production of the larger enterprises are approximately the same, then the socially optimal domestic output should be OK, which is the output of the small and larger enterprises when their private costs equal their social costs<sup>v</sup>.

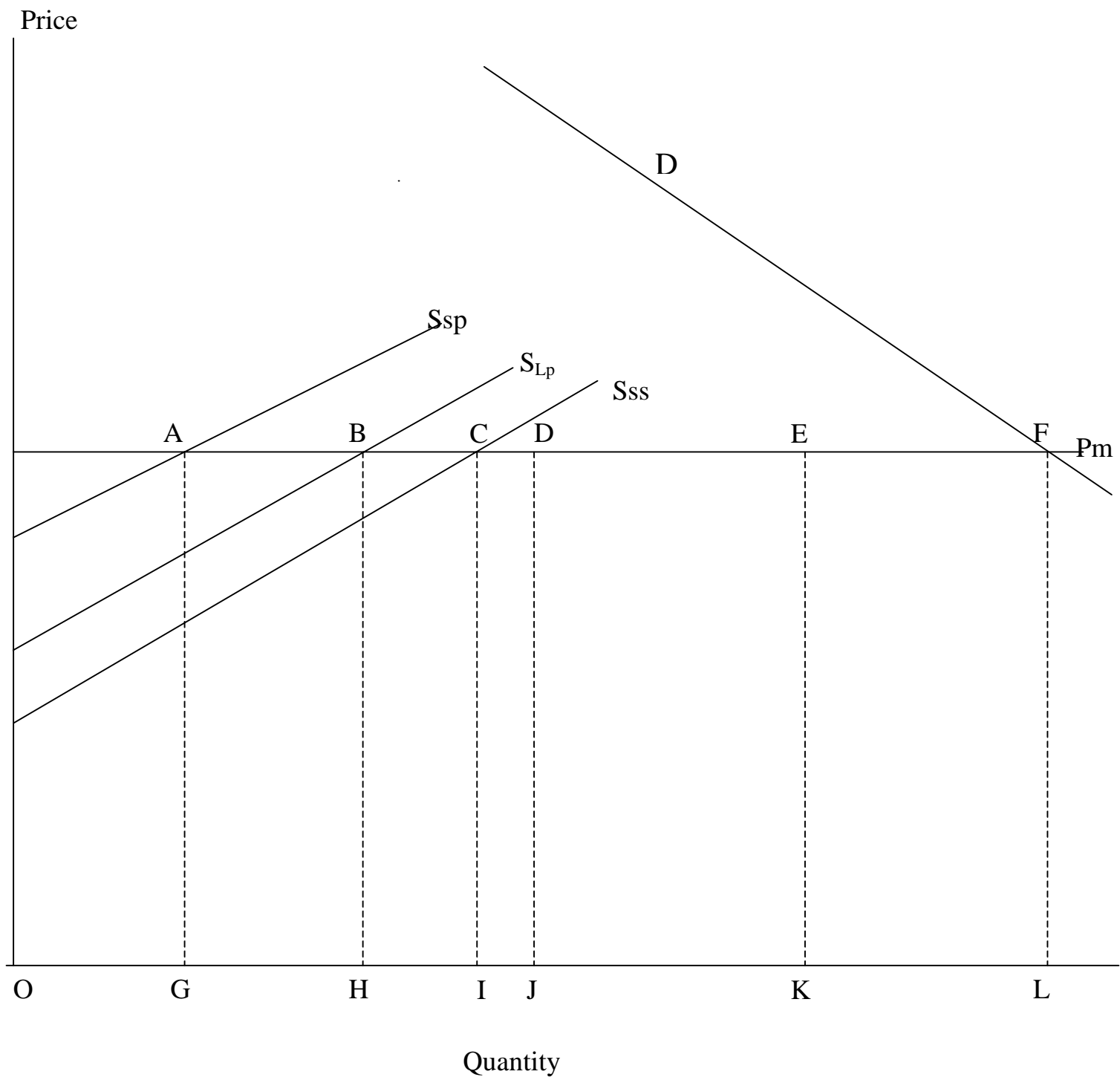
In order to achieve the socially optimal domestic output, economists argue that the **first best solution** is to subsidize the use of labor by making the cost of labor to the employers (after deducting the subsidy they receive for employing the labor) equal to the social cost of labor (the shadow wage rate)<sup>vi</sup>. However, this usually is not a practical solution nor an optimal solution because the cost of raising the funds to subsidize the wage rate to make it equal to the social cost of labor, and the administrative costs of paying the subsidy are too high (especially if there is **government failure**).

However, a **very important first step** in lowering the private cost of production of the small enterprises is to **eliminate any unnecessary extra costs** borne by them which unfairly increase their production costs such as unnecessarily complicated licensing and administrative procedures, illegal levies (pungli), etc., i.e. to give fair access to small enterprises. The Minister for Cooperatives, Small and Medium Enterprises, Adi Sasono, writes that the people's economy in essence is none other than a participative economy which gives fair and just access for all levels of society in the processes of national consumption, distribution and production without having to sacrifice the environment and natural resource functions as supporters of society's life-sustaining system ("Ekonomi rakyat pada intinya tidak lain adalah ekonomi partisipatif yang memberikan akses yang *fair* dan adil bagi seluruh lapisan masyarakat di dalam proses produksi, distribusi dan konsumsi nasional tanpa harus mengorbankan fungsi sumber-daya alam dan lingkungan sebagai pendukung sistem kehidupan masyarakat" (Sasono, p. 6). Also if the private cost of credit of the small enterprises is higher than the social cost of credit (commonly because of a dependence on money lenders), efforts usually will be needed to expand the supply of credit provided by financial institutions at non-subsidized interest rates.

However, although the above measures do not make the small enterprise private costs of production decrease sufficiently to become equal to the social cost of production, which is caused by the private cost of labor being greater than the social cost, they do help. It seems there is no way which the government can efficiently lower the cost of labor to employers so it is equal to the shadow wage rate, so we are left with the problem of underutilization of labor and the private cost of production of especially small enterprises (if they are especially labor intensive) being larger than the social cost of production<sup>vii</sup>. In this analysis we are assuming that small enterprises employ laborers and pay them a wage rate.

For **self-employed persons** and self-employed persons working together with family members who share in this family income, there is little or no divergence between the private and social cost of labor. This is because the self-employed person and family members are free to determine how long they want to work. They can increase their minutes worked up to the point at which their marginal opportunity cost of labor per minute worked increases and becomes equal to their decreasing marginal benefit from the work<sup>viii</sup>. Their marginal benefit is the happiness or utility from the income earned from the last minute worked.

Figure 1



$$OG + OH = OJ$$

$$OH + OI = OK$$

7.1



## Taiwan

Taiwan has been very successful in terms of development of SMEs. Its approach to assisting small enterprises has been different from India's. The Taiwanese Government in facilitating SME development for the most part emphasizes **making them more competitive on the supply side**, rather than restricting larger enterprises from competing with them or reserving the production of certain products to small enterprises. "The first Article of the Statute for the Development of SMEs sets out Taiwan's SME policy as "..... the furtherance of the sound development of medium and small businesses by helping them to improve their operating environment, promoting mutual cooperation among them, and assisting them to strive for growth through their own efforts...." "Assistance and guidance aims at maintaining SME business competitiveness." (White Paper on Small and Medium Enterprises in Taiwan, 1998, p. 150).

The Government has never undertaken substantial safeguarding measures for SME activities, although from 1970-1980 there were some restrictions on the manufacturing and processing sector.

This White Paper identifies some ways that existing legislation is biased against SMEs. For example, "...the 46th Article of the Audit Law decrees that state and public enterprises and organizations must enjoy priority in project negotiation", which negatively affects SMEs. However, the White Paper on Small and Medium Enterprises in Taiwan, 1998 recommends that "in Government project tenders with an amount less than a decreed minimum amount, SMEs are to be furnished with a priority status" (p. 171).

The Statute for Development of Small and Medium Enterprises advocates assistance and encouragement of SMEs but not protection. Article 4 states "For achieving the objectives of this statute, the competent authority concerned shall take appropriate assisting or encouraging measures in respect of the following matters:

1. Market research and development,
2. Furtherance of rationalization of business operations,
3. Promotion of mutual cooperation,
4. Acquisition and securing of production factors and technology,
5. Education and training of competent personnel, and
6. Other matters relating to the establishment or sound development of medium and small businesses.

## Indonesia

Indonesia also reserves the production of certain products for small enterprises although the list contains only 32 categories of goods and services, with some of the categories containing several types of goods and services. These are listed in Presidential Decision No. 99 in 1998 [Keputusan Presiden Republic Indonesia Nomor: 99 Tahun 1998 tentang Bidang/Jenis Usaha Yang Dicadangkan Untuk Usaha Kecil dan Bidang/Jenis Usaha Yang Terbuka untuk Usaha Menengah atau Usaha Besar dengan Syarat Kemitraan]. Imports for most of the products are small but some of them could easily increase.

The following is a list of some of the goods reserved for small producers (usaha kecil)<sup>ix</sup>:

1. The raising of non purebred chickens (peternakan ayam buras): Imports of frozen and non-frozen fowls were \$346,834 in 1998 according to Badan Pusat Statistik, Statistik Perdagangan Luar Negeri Indonesia: Impor 1998.
2. Bakery Products (roti, kue-kue kering dan sejenisnya): Imports of bakery products (SITC 0484) were \$1,520,584 in 1998.
3. Flour made from rice, cassava and different kinds of nuts (tepung beras, gaplek & tepung kacang2an): Imports of rice flour were \$23,888 in 1998.
4. Agricultural tools (alat pertanian): Imports of mattocks, picks, hoes and rakes were \$22,635 and spades and shovels and forks were \$24,338 in 1998 (included in hand tools below).
5. Tools for cutting (alat pemotong): Imports of knives and cutting blades for woodworking, agriculture or forestry were \$12.4 million in 1998 (included in hand tools below)
6. Hand tools (alat pertukangan): Imports of tools for use in hand or in machines (SITC 695) were \$112,670,131 in 1998.
7. Water meters for residences (rumah meteran air minum): Imports of liquid meters in 1998 were \$3,857,091.

The possibility that bans on medium and large enterprises (perusahaan menengah dan besar) increasing their output may result in a substantial increase in imports, although this may not be serious for most products. However, this could be a problem with bakery products (roti, kue-kue kering dan sejenisnya); agricultural tools such as hoes, plows, harrows, agricultural forks, sickles, etc. (alat pertanian seperti cangkul, bajak, garu, garpu tanah, sabit, dsb.), tools for cutting such as machetes, axes and large-bladed knives for cutting wood (alat pemotong seperti parang, kapak dan bendo), plantation tools such as knives, rubber collection cups, and coffee and cashew husking machines (alat-alat perkebunan seperti pisau dan mangkok sadap karet, mesin pengupas kopi, and mesin pengupas mete); and tradesmen's tools such as hand saws and small hammers (industri alat pertukangan such as gergaji tangan, palu/martil (tipe kecil); where especially competition from Asia can be very strong. Because this Presidential Decree was only issued in 1998, it is still too early to know its effect on imports and domestic production.

#### *Another Potential Problem even When the Commodity is Non-tradeable<sup>x</sup>*

Medium and large enterprises may produce a large portion of the production of a commodity reserved for small enterprises. This is very likely an indication that at least for certain varieties of the product they are the most competitive. If this is true, the banning of increased production by medium and large enterprises will cause the cost of production and price to increase and consumers/purchasers will suffer, assuming that the domestic price is determined by domestic supply and demand, not by the price of imports.

Examples of Indonesian commodities reserved for small enterprises where medium and large enterprises account for much of the production are "dry" bakery products (roti, kue kering dan sejenisnya); soybean cake (tahu); various kinds of chips (berbagai macam kerupuk); deep-fried, boiled, or steamed cakes (kue-kue basah); Indonesian traditional medicine "jamu" (jamu); lime (kapur); clay bricks (batu bata dari tanah liat); clay tiles (genteng dari tanah liat); agricultural tools (alat pertanian), tradesmen's tools (alat pertukangan), and cutting tools (alat pemotong).

One could say that if the small enterprises are competitive, then the reservation schemes are not needed. If they are not competitive with the ML enterprises, then the main result may be either an increase in imports, or consumers will pay higher prices--a kind of subsidy from consumers to small producers. If small enterprises deserve to be subsidized because they have a lower social cost of production than larger ones, even though their private cost of production is higher (because they are more labor-intensive with lower capital-output ratios in regions like Java with extensive unemployment causing the shadow price of unskilled labor to be less than the market wage rate), a subsidy to the production may be able to be justified, provided that the cost of providing the subsidy is not too high.

In theory the **first best** action is to subsidize the use of unskilled labor. This often is not practical because the administrative costs are too high, and it also may not be politically feasible.

However, **second best** is to subsidize output, which is what the reservation schemes and government favoritism in purchases towards small enterprises do.

This is better than subsidizing the cost of capital by subsidizing credit, because credit subsidies not only increase output, but also increase the ratio of capital to labor, which is the opposite of what is needed.

A commonly found situation is that both the private cost of labor and the private cost of capital for the small enterprises are greater than their social costs. Therefore there may not be much distortion in the capital labor ratio used, but the private cost of production is much higher than the social cost of production, causing the small enterprises great difficulty in competing with the ML enterprises.

If through the development and spreading of the organized credit market small enterprises are able to obtain credit at the social cost of capital, this will make them more competitive, but the private price of labor will still be too high relative to the private cost of capital, and their private cost of production will still be substantially higher than their social cost if they are very unskilled labor-intensive. Perhaps some consideration should be given to some kind of tax deduction or subsidy for the use of unskilled labor, to lower the cost of employment paid by the employer (after deducting the savings from the tax deduction or subsidy from the wages paid) and make it closer to the social cost of capital.

In Indonesia many small enterprises do not have access to credit through the formal financial institutions, but rather depend on their own resources, those of friends and relatives, and on others (i.e. private money lenders) (Saleh et al, 1999, p. 7). This makes it very likely that for many of the small firms their cost of credit is higher than the social cost of credit to them.

Therefore **Government promotion of the expansion of credit to small enterprises through financial institutions at interest rates approximating their social cost of capital** will result in an increase in the competitiveness of small enterprises relative to larger enterprises and a **resultant increase in allocative efficiency**.

## **GOVERNMENT FAVORITISM TOWARDS SMALL ENTERPRISES IN PURCHASING**

India, the USA, Taiwan and some European Community countries favor some small enterprises in their procurement of goods and services. For example, in India, Government purchases of 409 items have been reserved entirely for small-scale sector units, "and purchasing officers have to show that a large-scale supplier is 15% cheaper before being permitted to place an order outside the small-scale sector"(Harper, p. 125, and Com, p. 291). In the European Community nine countries have suppliers and contractors instruments favoring small businesses (Storey, 302).

In the USA small disadvantaged businesses are eligible for price adjustments of up to 10 percent when bidding on federal contracts in most industries ("Small Disadvantaged Business, What Can We Do"). Prime contractors achieving small disadvantaged business subcontracting targets are also favored. However, there are some other types of contracts where small businesses do not have to be disadvantaged to be favored, such as under the small business innovation program.

The Indonesian Government also favors small enterprises in its procurement of goods and consulting services. For up to one hundred million rupiah contracts only group C2 weak economic friends (rekanan golongan C2 golongan ekonomi lemah) are allowed to supply goods to the government. For more than one hundred million rupiah up to two hundred million rupiah in bidding on the supply of goods to the government the group C2 weak economic friends are given up to a 10 percent preference compared to the other C2 economic friends--if a group C2 weak supplier's price is ten percent or less more than the other C2 bidders' prices, it wins the tender (Keputusan President Republik Indonesia Nomor 24 Tahun 1995..., section 6). Only the group C2 friends are allowed to bid for the tender.

In real terms [after deflating values by the composite consumer price index (indeks harga konsumen gabungan)] the sizes of the government contracts for which smaller enterprises are favored has dramatically decreased since this Presidential Decision was issued. This is because the sizes of contracts in money terms for which small enterprises are favored has not changed since 1995. For example a hundred million rupiah contract in 1998, in real terms would only be a 55 million rupiah contract in 1995<sup>xi</sup>. So one could say that for up to a 100 million rupiah contract only group C2 weak economic friends were allowed to supply goods to the government in 1995, but in 1998 only they were allowed to supply goods to the government for contracts up to 55 million rupiah (in 1995 prices). As inflation continues and the rupiah size of the government contracts reserved for different sized enterprises is unchanged, the favoritism towards small enterprises steadily decreases.

This 1995 Presidential Decision favors small enterprises more than the previous 1994 Presidential Decision on the same subject, implementing the national budget (Anggaran

Pendapatan dan Belanja Negara), because in the 1994 decision the enterprises allowed to bid on these contracts are restricted only by whether they are weak economic group enterprises or not, temporarily meaning indigenous enterprises, not by size, except that weak economic group enterprises are defined in both the 1994 and 1995 Presidential Decisions as enterprises in the trade and services sector as having less than Rp 100 million in net wealth [kekayaan bersih (netto)] while those in the industrial and construction sectors must have net wealth less than Rp 400 million (Keputusan Presiden Republik Indonesia Nomor 16 Tahun 1994..., Paragraph 23). As shown below, the 1995 Presidential Decision states that both C1 and C2 enterprises must have their net wealth being less than or equal to Rp 100 million.

For government procurement of goods over two hundred million up to five hundred million rupiahs, only group C1 friends are allowed to bid, and for tenders over five hundred million up to one billion rupiahs the tender is among group B friends. For tenders up to one billion rupiahs the tenderers also must be local (setempat) enterprises. For tenders over one billion, friends from all sizes of enterprises and from all regions are allowed to bid according to the 1995 Presidential Decision.

The sizes of the groups of enterprises are defined also in section 14 of this Presidential Decision. In terms of their net wealth (kekayaan bersih) group **C2** is defined as having net wealth above Rp 5 million to 25 million, group **C1** above 25 million to 100 million, group **B** above 100 million to 200 million, and group **A** more than 200 million rupiahs. Net wealth is defined as liquid and fixed assets minus short- and long-term debts. In the explanation of this section in both the 1994 and 1995 Presidential Decisions it is stated that to be a weak economic group enterprise (perusahaan golongan ekonomi lemah) 50% or more of the enterprise's capital must be owned by the weak economic group, and that the granting of the opportunities for weak economic group are given temporarily to indigenous Indonesians ("untuk sementara pemberian kesempatan kepada golongan ekonomi lemah itu diberikan kepada orang Indonesia asli")(Angka 5). The 1995 Presidential Decision added that included in Indonesian indigenous persons are those who have assimilated as indigenous Indonesians (Termasuk ke dalam orang Indonesia asli ialah mereka yang sudah membaur sebagai orang Indonesia asli)(Explanation of the 1995 Presidential Regulation, Paragraph 21, Sentence 5).

To summarize, small indigenous enterprises (**group C2 weak economic group**) are given the greatest preference in supplying goods to the government, but all the smaller enterprises (**groups C2 as a whole, C1, and B**) are assisted by not allowing bigger firms to bid for the government business. Also only local enterprises are allowed to bid for contracts one billion rupiahs and less.

These measures, like the reservation schemes, are designed to increase the demand for the commodities produced by small enterprises from the local area in which the goods are to be supplied. Here, instead of private customers paying the higher prices as is the case with reservation schemes, taxpayers bear the burden. Like the reservation schemes, this favoritism does not distort the factor prices. Also, the likelihood of this favoritism towards small enterprises resulting in an increase in imports is small, especially since Paragraph 23 of both the 1994 and 1995 Presidential Decrees state that suppliers are to use Indonesian made products to the maximum amount possible in supplying goods/services to the government

("Departemen/Lembaga dalam melaksanakan pengadaan barang/jasa memperhatikan ketentuan sebagai berikut: a. semaksimal mungkin menggunakan hasil produksi dalam negeri ....").

If we compare these three schemes to assist small enterprises, **1**) product reservation scheme, **2**) government favoritism in purchasing from smaller enterprises, and **3**) government subsidization of credit, **1** and **2** are attractive relative to **3** because they do not distort the factor prices--make credit (the cost of capital) low relative to the cost of labor, which is likely to cause enterprises to use more capital and less labor, exactly the opposite of what is desired when there is extensive unemployment. Product reservation schemes have the disadvantage that for some products the main impact is an increase in imports rather than an increase in production by small enterprises. However, if there is a premium on government funds, **2** and **3** are unattractive relative to **1** because they require an increased government budget.

Government subsidization of credit definitely causes inefficiency in the allocation of resources, whereas **1** and **2** can cause an increase in the efficiency of allocation of resources if the output of the smaller enterprises increases relative to the larger ones, assuming that the larger enterprises are more capital-intensive than the smaller ones, although the efficiency does not necessarily increase. It does not necessarily increase because even though a desired increase in the production of the more labor-intensive smaller enterprises occurs, the increase in output can be too large. It does not correct the basic factor price distortion which is the cause of the allocative inefficiency in the first place, namely that the shadow wage rate (social cost) of unskilled labor is less than the money wage rate.

To directly correct the distortion, a subsidy for the use of labor must be made to employers so that the money wage rate paid by them (after deducting the subsidy) decreases and becomes equal to the shadow wage rate. However, this is administratively difficult, requires a lot of information, and is costly to implement. It also requires the use of scarce government budgetary resources to pay the subsidies. As an alternative approach the possibility of giving tax credits to enterprises for the use of unskilled labor should be examined. Such tax credits in theory should automatically assist labor-intensive enterprises more than capital intensive ones, and smaller enterprises relative to larger ones if indeed they are more labor-intensive. However, tax credits are likely to be of more importance to larger enterprises than small ones, because they are more likely to be paying income tax and therefore be able to benefit from the tax credit.

### **EFFECTIVE RATES OF PROTECTION FAVORING LARGE ENTERPRISES<sup>xii</sup>**

In some countries the effective rates of production tend to be high on the production of products by large enterprises and tend to be low on those dominated by small firms. For example, Anderson and Khambata found that in the Philippines, sectors generating two-thirds of the small-scale production had negative real rates of protection while sectors producing on a large scale had rates between 25% and 500%. "In Indonesia, Hiemenz and Bruch found a negative relationship between the importance of small-scale producers and protection rates (1983) while in Malaysia, von Rebenau showed that the average size of plants is bigger in highly protected industries (1976)" (cited from Uribe-Echevarria, 25-26).

These are examples where Government policy has probably unintentionally reduced the demand for the products produced in a large part by small enterprises by giving the production of their

products a lower effective rate of production. This is probably particularly true for the many agricultural exportables that are produced mainly by small farmers. Also because Indonesia has a comparative advantage in labor-intensive manufactures and some agro-industries, even though import duties on their products might be high, in many cases they will be wholly or partly redundant because domestic competition will have pushed the domestic price down below the landed cost of imported substitutes.<sup>xiii</sup> To the extent that smaller enterprises are more important producers of these labor-intensive products, compared with the more capital-intensive products for which the import duties are generally not redundant in Indonesia, the protection against imports will be biased against smaller enterprises. This and the relationship between effective rates of production and the products produced predominantly by small enterprises need to be further researched in Indonesia.

## SUMMARY AND CONCLUSIONS

We now summarize the advantages and disadvantages of the seven policies that have been used to promote small and medium enterprises. These are shown in Table 1 below.

**Table 1. Advantages and Disadvantages of Policies to Promote Small and Medium Enterprises**

Policy	Advantages	Disadvantages
1. Product reservation for small enterprises	<p>1. The increase in demand for products of SEs does not distort factor prices, but also does not correct distortions in factor prices</p> <p>2. The cost of the increase in demand is borne by consumers, not by the government budget</p>	<p>1. If the products of small enterprises are also imported, the result of the policy can be an increase in imports with little or no increase in the production of small enterprises</p> <p>2. If there are no imports and the cost of production of SEs of the reserved products is substantially greater than larger enterprises, there will be a substantial increase in the products' prices to consumers</p>
2. Government favoritism in purchases towards small enterprises	<p>1. The increase in demand for products of SEs does not distort factor prices, but also does not correct distortions in factor prices</p> <p>2. Unlikely to cause an increase in imports</p>	<p>1. The cost of the increase in demand is born by the government budget</p> <p>2. If there are no imports and the cost of production of SEs of the reserved products is substantially greater than larger enterprises, there will be a substantial increase in the products' prices to the government</p>

<p>3. Government facilitation of the supply of credit by supporting the spreading and expansion of formal financial institutions, without subsidizing interest rates</p>	<p>1. Does not distort factor prices, but instead makes the cost of credit to SMEs closer to the social cost of capital by increasing the amount of credit supplied through the formal financial institutions rather than informal lenders such as money lenders.<sup>1</sup> This increases the competitiveness of small relative to large enterprises if small enterprises are more dependent on informal lenders for their credit than larger enterprises, as is usually the case.</p> <p>2. Does not create any incentive for rent-seeking behavior</p>	<p>1. There will likely be some cost to the government budget, but it will be relatively small, especially compared with subsidized credit schemes</p>
<p>4. Government subsidized credit to SMEs</p>	<p>1. Assists the lucky SEs who are able to access the subsidized credit supplied, which we assume is less than will be demanded by the SEs</p>	<p>1. Encourages rent-seeking behavior by SEs, including the bribing of persons making decisions about the allocation of the credit</p> <p>2. Makes the private cost of capital for the recipients less than the social cost, and encourages the firms to use excessively capital-intensive production processes</p> <p>3. Is costly to the government budget</p>
<p>5. Subsidize the use of unskilled labor so the price of labor to all enterprises is closer to the shadow wage rate</p>	<p>1. Results in the enterprises using closer to the optimal amount of unskilled labor in their production, and decreases the ratio of the private cost of production to the social cost of production for SEs relative to larger enterprises, who are assumed to use more capital intensive production processes</p> <p>2. Combined with policy 3, results in the ratio of unskilled labor to capital used being closer to the socially optimal ratio, and the private cost of</p>	<p>1. Difficult administratively and costly to implement, because it would involve the subsidization of unskilled labor of millions of enterprises</p> <p>2. Would place a heavy burden on the government's budget</p>



	production being less and closer to the social cost of production for all the enterprises. Given that the social and private costs of the larger enterprises are also approximately equal, this makes the competition between SEs and larger enterprises much fairer	
6. Give enterprises a tax credit for the use of unskilled labor	<p>1. Has the advantages of policy 5, except that the money wage rate (after taking account of the tax credit) will still be higher than the shadow wage rate, even if it becomes closer to it</p> <p>2. Is administratively simpler than policy 5</p>	<p>1. Is still costly in terms of the government's budget, through loss in tax revenues</p> <p>2. Is likely to be utilized more by larger enterprises, who are more likely to be paying income tax, and therefore able to benefit from the tax credit</p>
7. Eliminate unnecessary extra costs to small enterprises by eliminating or simplifying licensing, red tape, administrative procedures and inefficient and illegal levies	<p>1. Can be done at a relatively low cost</p> <p>2. Does not create any distortions</p>	<p>1. Does not make social and private costs of labor equal and does not make the social and private costs of credit (capital) equal, so the capital-labor ratios will still be higher than is socially optimal, and more labor-intensive small enterprises will still be disadvantaged relative to larger enterprises</p>

<sup>1</sup>Even if the interest rate decreases and becomes equal to the social cost of capital, if there is a lot of unemployment the shadow wage rate is still less than the money wage rate, so the ratio of the social cost of unskilled labor to the market cost of unskilled labor is still less than the ratio of the social cost of capital to the market cost of capital. Therefore enterprises will still use less unskilled labor and more capital than is socially desirable.

Which of these policies are therefore attractive in their optimal forms? To some degree the implementation of policies **3**, **5** and **6** will be attractive. Policy **7** should be given a very high priority because its potential benefits are high relative to its costs. Policies **2** and **4** should only be applied with great caution--only when there are very strong arguments to justify them. In general, policy **1** is not recommended.

The future development of Java and other very densely populated parts of Indonesia will be very dependent on the development of efficient globally competitive manufacturing industries.

Primary industries can be the leading sectors in most of the outer islands but in Java only manufacturing can be the main leading sector which will bring a multiple increase in per capita incomes over the next two or three decades. Therefore it is very important that small and medium manufacturing establishments strongly be encouraged to become as efficient as possible, and that small enterprises become the seedbed for medium-sized enterprises, and medium-sized for large enterprises. In other words, they should be encouraged to grow, not to remain small to benefit from restrictions and subsidies. Because of this, as in Taiwan, the emphasis needs to be placed on the supply side, increasing their competitiveness, rather than encouraging lethargy and complacency through protection against competition from other domestic producers and imports.

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## ENDNOTES

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i. See T. Y. B. Com, pp. 293 and 311.

ii. For a discussion of social and private costs and the shadow price of unskilled labor see Gray et al, pp. 8-11 and 116-119, or Kadariah, pp. 2-17 and 94.

iii. One definition of government failure is inefficient government budget allocation, such as the oversupply of unnecessary public goods coexisting with the undersupply of public goods critically needed for economic development, that results in reduction of net social welfare (Hayami, p. 204). However, government failure can also take other forms such as poor and/or excessive regulations, excessive inflationary financing, the adoption of faulty policies or the poor implementation of good policies and programs, corruption, etc.

iv. Because of the extensive disguised and open unemployment found in the very densely populated areas of Indonesia such as Java and Lombok, the social cost of unskilled labor is less than the private cost (the market wage rate). The social cost of labor is also called the shadow wage rate and is very closely related to the opportunity cost of labor concept. If small enterprises use a lot of unskilled labor, their cost of production in social terms will be substantially less than their private cost of production (cost of production in money or financial terms). For companies using little unskilled labor relative to capital, the social cost of production will only slightly be less than their private cost of production.

v. If the production of the larger enterprises is not stopped, but only not allowed to increase, then with increases in the supply schedules of the small and larger enterprises and an increase in the demand schedule over time, the ban on increases in production of the larger enterprises will result in a greater increase in imports compared with the situation when there are no bans on the increase in output of the larger enterprises as long as the increase in quantity demanded at the import price is greater than the increase in the quantity supplied by the small enterprises at this price.

vi. So if the employers pay the market wage rate  $w$ , their cost of employing the labor is  $w - s = w_s$ , where  $s$  is the subsidy they receive and  $w_s$  is the social cost of labor.

vii. By labor intensive we mean the ratio of labor used to capital used in the production process is high.

viii. The marginal opportunity cost of their labor is the happiness or

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utility from the net income per minute they give up by doing this work compared with their next best alternative use of time plus any decrease in utility from this work per minute compared with their next best alternative. Utility maximizers will work up to the point at which their marginal disutility from the work increases and becomes equal to their marginal utility from the work.

ix. According to The Law of The Republic of Indonesia Number 9 of The Year 1995 Concerning Small Business three of the five criteria of small business are 1) having net wealth or resources not more than Rp 200,000,000 (Two hundred million rupiahs) excluding land and buildings that are used as a business place; or 2) having annual sales volume not more than Rp 1,000,000,000 (one billion rupiahs); 3) belonging to Indonesian citizen. It also must be a business standing on its own, not owned, dominated or having affiliation directly or indirectly with medium or big businesses.

x. Non-tradable means that the commodity is neither exported nor imported.

xi. To obtain this figure we have divided 100 million rupiahs by 1.8166, because the composite consumer price index of 27 cities (44 cities in 1998) increased 81.66 percent from 1995 to 1998. This was calculated using data from Table 9.5.3 in Badan Pusat Statistik, Statistik Indonesia 1998.

xii. The effective rate of protection (ERP) in percentages is measured by the formula  $(V-W)100/W$ , where **V** is the value-added of a production process in domestic prices and **W** is the value-added of the same production process in world or international prices. Protection against imports of products produced domestically raises their domestic price relative to their world prices and increases the value-added in domestic prices from producing the products relative to the value-added in world prices. **V** and **W** are calculated using the same currency.

xiii. The landed cost of an imported good is the cost insurance freight (c.i.f.) cost plus an increase in costs because of import duties and other taxes on imports.